

BEFORE THE STATE BOARD OF EQUALIZATION
OF THE STATE OF CALIFORNIA

In the Matter of the Appeal of)
JOHN W. AND JEAN R. PATIERNO)

For Appellants: Harold E. Mestyanek
Certified Public Accountant

For Respondent: Bruce W. Walker
Chief Counsel

Claudia K. Land
Counsel

O P I N I O N

This appeal is made pursuant to section 18593 of the Revenue and Taxation Code from the action of the Franchise Tax Board on the protest of John W. and Jean R. Patierno against a proposed assessment of additional personal income tax in the amount of **\$3,440.40** for the year 1973.

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This appeal presents two issues: (1) whether a loan fee paid in connection with the purchase of an apartment building was deductible as interest expense; and (2) whether appellants properly shortened the remaining useful lives of the real and personal property components of a second apartment building.

In December 1973, appellants entered into an agreement to purchase a 93-unit apartment building in Anaheim, California, for a total price of **\$1,255,100**. The seller, a partnership doing business as Executive Five, had an outstanding loan of \$847,500 secured by a first trust deed on the **property**, payable to American Savings and Loan Association (American). The American loan contained a prepayment penalty clause which would be **invoked** by the payment of over 20 percent of the loan in any one calendar quarter, or by the sale of the property. In order to avoid the prepayment penalty, the transaction was structured in the following manner.

Executive Five obtained a loan of \$940,000 secured by a second trust deed on the apartment building from Crown Life Insurance Company (Crown) through the agency of the Ralph C. Sutro Company (Sutro). Sutro was paid \$19,900 by Executive Five for its services in obtaining the loan commitment from Crown, and was to act **as disbursing agent of the loan proceeds**. The Crown loan was to be funded in installments which were to be applied by Sutro to the American loan in increments to retire it as quickly as possible without precipitating the prepayment penalty. At the time the American loan was fully paid and the Crown loan fully funded, appellants were to receive title to the property and to assume the Crown loan which would then be secured by a first trust deed on the property. During the interim period, until title **passed**, appellants were to manage the apartments and were entitled to all depreciation and other tax benefits derived from the apartment building.

In accordance with the terms of the agreement, on January 28, 1973, appellants paid \$100,017 on Executive Five's account with American. This amount represented an advance payment of a portion of the first advance due Executive Five from **Sutro**, of which \$80,217 represented a portion of the purchase price and \$19,900 was reimbursement of the loan fee paid Sutro by Executive Five.

Appellants deducted the \$19,900 loan fee as interest expense on their 1973 personal income tax

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return. Respondent determined that the fee was payment for Sutro's services rather than interest, and disallowed the deduction. Since the loan fee was paid by Executive Five and reimbursed by appellants, respondent determined that the payment was part of the purchase price and added the \$19,900 to appellants' basis in the apartment building. However, in redetermining appellants' liability after disallowing the deduction of the loan **fee**, respondent used straight-line depreciation where appellants had used accelerated depreciation. Respondent now concedes that accelerated depreciation was appropriate and has agreed to recompute appellants' allowable depreciation.

During July 1973, appellants sold a 27-unit apartment building in Tustin, California, which they had purchased in May 1969. For the year of **purchase**, appellants claimed accelerated depreciation, **as well** as additional first-year depreciation on the personal property, based upon useful lives of 25 years for the building and 6 years for the personal property. As of January 1, 1970, appellants changed to the straight-line method of depreciation; however, depreciation was computed on the original cost which was not reduced by the first-year depreciation. In addition, appellants shortened the useful life assigned to the real property by four **years**, and the useful life assigned to the personal property by one year. During the audit of **appellants'** 1973 return, respondent recalculated the depreciation, taking into account the first year's depreciation and using the useful lives originally assigned by appellants.

Section 17203 of the Revenue and Taxation Code provides for the deduction of "all interest paid or accrued within the taxable year on indebtedness." Interest is defined as compensation paid for the use or forbearance of money. (Deputy v. du Pont, 308 U.S. 488 [84 L. Ed. 416] (1940).) In order to qualify as deductible interest for tax **purposes**, the payment must be compensation for the use or forbearance of money and not compensation for services. (Lay v. Commissioner, 69 T.C. 421, 438 (1977).)

Appellants argue that, since the loan fee was not deducted from the loan proceeds but was paid to Executive Five as reimbursement, the fee is deductible in its entirety for the year in which it was paid. This argument presupposes that the payment **was**, in fact, interest. In this appeal, however, the amount in controversy was originally paid by Executive Five to Sutro

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for **Sutro's** services in obtaining a loan commitment from Crown. Therefore, the fee was reimbursement to Executive Five for its payment for services rendered, not compensation for the use or forbearance of money. (Compare Lay v. Commissioner, supra, 69 T.C. at 438 with Wilkerson v. Commissioner, 70 T.C. 240, 256 (1978).) Accordingly, respondent's action in disallowing the deduction was proper.

Respondent also determined that the loan fee, an expense incurred by Executive Five which was reimbursed by appellants as part of the purchase price, was part of the cost of acquisition and should be capitalized. Since appellants have offered neither argument nor authority in opposition to this treatment, respondent's action in this respect **must** also be upheld.

Next, we consider whether appellants properly shortened the remaining useful lives of the real and personal property components of the Tustin apartment building. Section 17208 of the Revenue and Taxation Code provides for a depreciation deduction for the exhaustion, wear and tear of property held for the production of income. In describing the useful life to be assigned to a depreciable asset, respondent's regulations provide, in part:

The estimated remaining useful life may be subject to modification by reason of conditions known to exist at the end of the taxable year and shall be redetermined when necessary, regardless of the method of computing depreciation. However, estimated remaining useful life shall be redetermined only when the change in the useful life is significant and there is a clear and convincing basis for the redetermination. (Cal. **Admin.** Code, tit. 18, reg. 17208, subd. (a)(2).)

Respondent's determination of a proper depreciation allowance is presumed to be correct. The burden of showing the determination to be incorrect is on the taxpayer. (Appeal of Peninsula Savings and Loan Association, Cal. St. Bd. of Equal., **Jan. 2, 1974.**) In this appeal, the only reason advanced by appellants for shortening the lives originally attributed to the assets was appellants' unsupported belief that the shorter lives were more representative of the assets' actual economic lives. This is not enough to satisfy appellants' burden. Accordingly, we must sustain **respon-**

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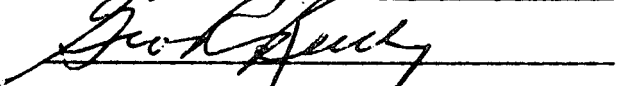
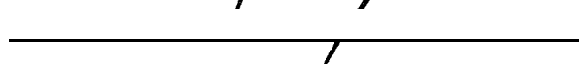
dent's action in requiring the use of the longer useful lives originally selected by appellants in calculating allowable depreciation.

O R D E R

Pursuant to the views expressed in the opinion of the board on file in this proceeding, and good cause appearing therefor,

IT IS HEREBY ORDERED, ADJUDGED AND DECREED, pursuant to section 18595 of the Revenue and Taxation Code, that the action of the Franchise Tax Board on the protest of John W. and Jean R. Patierno against a proposed assessment of additional personal income tax in the amount of \$3,440.40 for the year 1973, be and the same is hereby modified in accordance with respondent's concession. In all other respects, the action of the Franchise Tax Board is sustained.

Done at Sacramento, California, this 30th day of June , 1980, by the State Board of Equalization.

 , Chairman
 , Member
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 , Member
 , Member